Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

FCC 92-256
38414

In the Matter of	)	
	)	
Amendment of Parts 65 and 69 of	)	
the Commission's Rules to Reform	)	CC Docket No. 92-133
the Interstate Rate of Return	)	
Represcription and Enforcement	)	
Processes	)	

NOTICE OF PROPOSED RULEMAKING AND ORDER

Adopted: June 18, 1992; **Released:** July 14, 1992

Comment Date: September 11, 1992
Reply Comment Date: October 13, 1992

By the Commission:

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I. EXECUTIVE SUMMARY

1. In this Notice of Proposed Rulemaking, we continue our efforts to reduce regulatory burdens by undertaking fundamental reform of our rate of return represcription and enforcement processes. Those processes, which are set forth in our Part 65 rules,[1] reflect a telecommunications industry and a regulatory environment that has changed dramatically since the rules' adoption in 1985.

2. When Part 65 was adopted, the Commission regulated the interstate communications services of the American Telephone and Telegraph Company (AT&T) and local exchange carriers (LECs) on a rate of return basis. Since that time our price cap initiatives have removed all interexchange and most interstate access revenues from rate of return regulation. Carriers whose interstate services remain primarily under rate of return regulation now generate only

[1] 47 C.F.R. Part 65.

about 6.3% of total LEC revenue.[2]

3. To reflect this different environment, we invite comment on virtually all aspects of our represcription and enforcement processes. We propose to change: (1) how we begin represcription proceedings; (2) how we conduct them; and (3) how we estimate the cost of capital during their course. We also propose to change the Part 65 enforcement rules in light of the Automatic Refund Decision,[3] which remanded the Part 65 automatic refund rule.

4. The current rules contemplate a new represcription proceeding every two years regardless of conditions in the capital markets. We propose to begin represcription proceedings only when market indicators show significant changes in the cost of capital that are likely to persist over time. We believe that this change would allow us to initiate represcription proceedings only when they are warranted.

5. The current rules establish a "paper hearing" process for represcription proceedings that is patterned after the system used in evidentiary hearings. Not only does this process result in a redundant record, it also imposes heavy burdens on the participants and this Commission. We propose to replace this process with a notice and comment system that, we believe, would eliminate many of the unnecessary burdens of the represcription process.

6. Part 65 uses a weighted average cost of capital calculation to determine a unitary, overall rate of return for rate of return LECs. While we propose no change in our policy of prescribing a unitary, overall rate of return, we propose to change how we estimate the cost of debt, cost of equity, cost of preferred stock, and capital structure components of that return. We invite comment on alternative methodologies for estimating those components and on the role any methodologies we select should play in future represcription proceedings.

7. The Automatic Refund Decision was based on the United States Court of Appeals for the District of Columbia Circuit's view that the Commission's prescribed rate of return represented both the maximum and the minimum return that the Commission could prescribe. In response to that decision, we make clear that the prescribed rate of return is a point within a broad zone of reasonableness that is neither the maximum nor the minimum return necessary to meet constitutional standards. To enforce that rate of return, we propose to rely on the tariff review and complaint processes. However, we invite comment on whether we should adopt a refund rule to supplement those processes.

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[2] In Regulatory Reform for Local Exchange Carriers Subject to Rate of Return Regulation, Notice of Proposed Rule Making, CC Docket No. 92-135, FCC 92-258 (adopted, June 18, 1992) (Regulatory Reform Notice), we propose to correct efficiency disincentives for these carriers.

[3] AT&T v. FCC, 836 F.2d 1386 (D.C. Cir. 1988) (per curiam) (Automatic Refund Decision).

8. The proposals in this Notice seek to simplify the rate of return represcription and enforcement processes so they do not impose unnecessary burdens on the telecommunications industry as it continues to develop. In making these proposals, we are attempting to ensure that carriers will continue to have the opportunity to maintain their credit and attract capital and that interstate rates will remain just and reasonable.

II. INTRODUCTION

9. Part 65 of our rules sets forth procedures and methodologies for prescribing and enforcing the rate of return certain LECs are authorized to earn on interstate access service. In this Notice, we propose to reform those rules to reflect our experience in the 1990 represcription proceeding,[4] LEC price caps,[5] and our incentive regulation proposals for non-price cap LECs.[6] We anticipate adopting streamlined procedures and methodologies that will reduce the burden of the rate of return represcription and enforcement processes, while allowing each remaining rate of return LEC the opportunity to "maintain its credit and to attract capital."[7]

III. REPRESCRIPTION PROCEDURES AND METHODOLOGIES

A. Background

10. Since divestiture, the Commission has undertaken two rulemakings to streamline the rate of return represcription process. In the first of these rulemakings, CC Docket No. 84-800, the Commission sought to develop rules that would permit it to represcribe the authorized rate of return for LEC interstate access service and AT&T's interstate communications services without engaging

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[4] Represcribing the Authorized Rate of Return for Interstate Services of Local Exchange Carriers, Order, 5 FCC Rcd 7507 (1990)(1990 Represcription Order), recon. denied, 6 FCC Rcd 7193 (1991)(1990 Represcription Reconsideration Order), petitions for review docketed sub nom., Illinois Bell Telephone Co., et al. v. FCC, No. 91-1020 (D.C. Cir. filed January 11, 1991).

[5] Policy and Rules Concerning Rates for Dominant Carriers, Second Report and Order, 5 FCC Rcd 6786 (1990) and Erratum, 5 FCC Rcd 7664 (1990) (LEC Price Cap Order), modified on recon., 6 FCC Rcd 2637 (1991), petitions for further recon. dismissed, 6 FCC Rcd 7482 (1991), further modified on recon., 6 FCC Rcd 4524 (1991)(ONA/Part 69 Order), petitions for recon. of ONA/Part 69 Order pending, appeals of LEC Price Cap Order docketed sub nom. District of Columbia Public Service Commission v. FCC, No. 91-1279 (D.C. Cir. filed June 14, 1991).

[6] See Regulatory Reform Notice, supra.

[7] FPC v. Hope Natural Gas, 320 U.S. 591, 603 (1944). See also Bluefield Water Works v. PSC, 262 U.S. 679, 693 (1923).

in traditional, trial-type hearings.[8] These efforts culminated in the adoption of the rate of return procedures and methodologies in our current Part 65 rules. Those rules establish a "paper hearing" process for represcription proceedings and set forth substantive methodologies for possible application in the course of that process. This process replaced the trial-type hearings the Commission had previously used to represcribe the authorized interstate rate of return.

11. The Commission conducted the 1986 represcription proceeding under the Part 65 rules.[9] Although that experience was largely successful, it revealed some flaws in the rules. In CC Docket No. 87-463, the Commission proposed to refine the rules to eliminate those flaws.[10] In proposing refinement, the Commission recognized that its price cap initiative might require fundamental reform of the represcription process.[11] However, rather than proposing fundamental reform at that time, the Commission invited comment on only those revisions that promised to be helpful in the next represcription proceeding.[12]

12. That represcription proceeding began during February 1990, prior to any Report and Order in Docket 87-463. In initiating the represcription proceeding, the Commission rejected suggestions that it should not undertake a represcription until it had refined the rules as proposed in Docket 87-463. Instead, the Commission conducted the 1990 represcription proceeding pursuant to the Part 65 rules, while waiving those rules to the extent necessary to correct for flaws revealed in the 1986 represcription proceeding and to recognize other post-divestiture developments.[13]

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[8] Authorized Rates of Return for the Interstate Services of AT&T Communications and Exchange Telephone Carriers, Report and Order, CC Docket No. 84-800, Phase II, 51 Fed. Reg. 1795, at paras. 3, 70-72 (Jan. 15, 1986) (Phase II Order), recon. 104 FCC 2d 1404 (1986) (Phase II Reconsideration).

[9] Authorized Rates of Return for the Interstate Services of AT&T Communications and Exchange Telephone Carriers, Report and Order, CC Docket No. 84-800, Phase III, 51 Fed. Reg. 32920 (Sept. 17, 1986) (1986 Represcription Order), recon. denied, 2 FCC Rcd 5636 (1987).

[10] Refinement of Procedures and Methodologies for Represcribing Interstate Rates of Return for AT&T Communications and Local Exchange Carriers, CC Docket No. 87-463, Notice of Proposed Rule Making, 2 FCC Rcd 6491 (1987) (1987 Notice).

[11] Id. at 6499, n.6.

[12] See id. at 6491, para. 4.

[13] Refinement of Procedures and Methodologies for Represcribing Interstate Rates of Return for AT&T Communications and Local Exchange Carriers, CC Docket No. 87-463, Order, 5 FCC Rcd 197, 202-03, paras. 47-49 (1989)(Interim Prescription Order), petition for recon. pending.

B. Need for Reform

13. When the Commission promulgated the Part 65 rate of return rules, it was attempting to develop a represcription system suitable for a post-divestiture environment in which virtually all the interstate services of AT&T, the Bell Operating Companies (BOCs), and other LECs were regulated on a rate of return basis. In developing that system, the Commission found it necessary to strike a balance between determining these carriers' capital costs with exactitude and determining them in a timely manner. As stated previously, the Commission concluded that a "paper hearing" process would strike the best possible balance between these interests, given the situation prevailing at that time.[14] The Commission accordingly incorporated such a process into the Part 65 rules. The Commission promised, however, that it would reexamine and change those rules if future circumstances warranted.[15]

14. Since the adoption of the Part 65 rules in 1985, the telecommunications industry and our regulation of it have changed considerably. New technologies and new forms of regulation have enabled the industry to provide its customers with an ever increasing array of services, both regulated and nonregulated. To help ensure that consumers receive regulated services at reasonable rates, we have adopted price cap systems that remove all of AT&T's, and virtually all of the BOCs' and certain other large LECs', interstate services from rate of return regulation.[16] The carriers whose interstate services remain primarily under rate of return regulation now generate only about 6.3% of total LEC revenue.

15. We believe that these changes require a fundamental reexamination of our represcription process, rather than mere refinement as proposed in Docket 87-463. As an initial matter, the Part 65 rules contain procedures for determining the cost of capital of interexchange carriers that are required by Commission order to be regulated on a rate of return basis.[17] There are no such carriers. This alone calls for some revision in our rules beyond that proposed in Docket 87-463.

16. More significantly, our current procedures and methodologies for determining LEC capital costs were designed to regulate the entire LEC industry. We question whether we should continue to rely on those procedures and methodologies for the remaining rate of return LECs. Our experience in the 1990 represcription proceeding demonstrated that our current rules require a

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[14] See Part III(A), supra.

[15] E.g., Phase II Order, at paras. 55, 69.

[16] LEC Price Cap Order, supra; Policy and Rules Concerning Rates for Dominant Carriers, Report and Order, and Second Further Notice of Proposed Rulemaking, 4 FCC Rcd 2873 (1989) (AT&T Price Cap Order), recon., 6 FCC Rcd 665 (1991) (AT&T Price Cap Recon. Order), appeal docketed sub nom. AT&T v. FCC, No. 91-1178 (D.C. Cir. filed Apr. 16, 1991).

[17] 47 C.F.R. §§65.500; 65.510.

cumbersome and expensive process for determining LEC capital costs.[18] We see no reason to apply the current procedures and methodologies in future represcription proceedings, particularly when the remaining rate of return LECs provide only a small portion of LEC interstate access service. On the contrary, we tentatively conclude that simplified procedures and methodologies will facilitate our efforts to ensure that interstate telephone rates are just and reasonable. We invite comment on this tentative conclusion.

17. In the remainder of this Part, we propose simplified procedures and methodologies that would affect virtually all aspects of how we prescribe rates of return. We propose to replace the current system with a notice and comment system that would eliminate many of the burdens of the represcription process. Under this proposal, represcription proceedings would begin only when changes in the capital markets show that they are needed, rather than in January of each even numbered year, as our current system contemplates. Interested persons would be able to participate in represcription proceedings through written filings and, under one alternative, would be able to obtain limited discovery from other parties. We invite comment on this proposed system.

18. We propose no change in our policy of prescribing a unitary, overall rate of return for rate of return LECs. We also intend to calculate that rate of return using a weighted average cost of capital. In order to simplify future represcription proceedings, however, we invite comment on alternative methodologies for determining the cost of equity, cost of debt, cost of preferred stock, and capital structure components of that average. We also invite comment on whether we should select methodologies for determining the non-equity components that would be binding in future represcription proceedings.

C. Initiating Represcription Proceedings

19. The Part 65 rules contemplate biennial represcription proceedings that begin during January of each even numbered year.[19] We believe that this schedule does not reflect how the cost of capital for LEC interstate access service changes over time. We also believe that we can estimate the changes by examining capital market data that are generally available to financial analysts and use our estimates to determine whether the changes are likely to persist. Accordingly, we propose to replace the current biennial trigger contained in Part 65 with a trigger based on changes in the capital markets. We invite comment on this proposal.

20. When the Commission adopted the rate of return rules, it expected that the two-year represcription cycle would bring regularity to the

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[18] See 1990 Represcription Order, 5 FCC Rcd at 7532, para. 220 (1990).

[19] See 47 C.F.R. §65.102(c).

represcription process.[20] This expectation has not been realized. On the contrary, the practice has been to defer represcription proceedings to devote administrative resources to more pressing matters. Thus, the next represcription proceeding is scheduled to begin on August 3, 1992.[21]

21. While we believe that the authorized rate of return remained within the zone of reasonableness during each of the deferral periods,[22] our experience with the current trigger has made clear that LEC capital costs do not track the calendar. Therefore, we tentatively conclude that we should abandon the two-year represcription cycle embodied in the current rules. In its place, we propose to adopt a trigger that allows us to identify when there has been a significant change in capital markets that is likely to persist over time. Such a trigger would allow us to initiate represcription proceedings only when they are warranted. We invite comment on these matters.

22. There are a wide variety of data and methodologies we could use to identify when capital costs have changed significantly. In the Interim Prescription Order, for example, we relied on interest rate data to determine whether the authorized rate of return required adjustment pending the completion of the 1990 represcription proceeding.[23] We could also compare past and current yields on financial instruments, such as long-term United States Treasury bonds. Alternatively, we could examine changes in discounted cash flow (DCF) cost of equity estimates for the Standard & Poors (S&P) 400, the Regional Bell Holding Companies (RHCs), 100 large electric utilities, or other publicly traded companies. We invite interested persons to discuss how we might use these and other available measures of capital costs to determine when we should initiate represcription proceedings.[24]

23. One possibility would be to select a single measure of capital costs and track how that measure changes over time. This could be done by calculating a moving average for that measure for the period surrounding the most recent represcription and for each subsequent month. If the two sets of averages deviated from each other by a specified amount (e.g., 100 basis

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[20] See Refinement of Procedures and Methodologies for Represcribing Interstate Rates of Return for AT&T Communications and Local Exchange Carriers, Supplemental Notice of Proposed Rule Making, Docket No. 84-800, 50 Fed. Reg. 33786, at para. 45 (1985) (Supplemental Notice).

[21] Deferral of Rate of Return Represcription Filings Pursuant to Section 65.102(c) of the Rules, 6 FCC Rcd 5863 (Com. Car. Bur. 1991) (1991 Deferral Order). In Part V, infra, we defer this proceeding, which was originally scheduled to begin on January 3, 1992, pending further action in this rulemaking.

[22] See, e.g., Interim Prescription Order, 5 FCC Rcd at 202, para. 46.

[23] Id., para. 45.

[24] Part III(E), infra, discusses cost of capital methodologies in greater detail.

points) for a specified period (e.g., six months), a represcription proceeding might be warranted. We request the commenters to address specifically whether we should use moving averages and, if so, how we should calculate those averages. Commenters should also address the amounts by which these averages must change and how long the change should persist to warrant a represcription proceeding. We invite commenters to address how often (i.e., monthly, quarterly, annually) we should determine whether the triggering event has occurred.

24. Implicit in the system described above is at least some minimal period between any future represcription proceedings.[25] We invite commenters to address whether we should extend this period of stability to ensure that our represcription decisions do not result in unduly frequent changes in interstate rates. We request that the commenters discuss, in particular, whether we should specify a minimum period during which future represcriptions would remain in effect absent extraordinary circumstances and, if so, what that period should be.

25. We also invite comment on how we should proceed once the triggering event occurs. We envision two possibilities: an automatic or a semi-automatic trigger. With an automatic trigger, a represcription proceeding would begin once the triggering event occurs. With a semi-automatic trigger, further analysis would occur to determine if a represcription proceeding is necessary. An automatic trigger would provide certainty, but could lead to unwarranted proceedings and ad hoc postponements of represcription proceedings. A semi-automatic trigger would provide flexibility, but could engender conflicts over the need for a represcription proceeding. We ask interested persons to discuss the merits of these alternatives.

26. Although we propose to adopt a trigger based on changes in capital markets, we believe we should consider alternatives to that proposal. Therefore, we invite comment on whether our rules should continue to specify a trigger based on the passage of time and, if so, what the represcription schedule might be. We also invite comment on the desirability of specifying no triggering mechanism in our rules.

D. Conduct of Represcription Proceedings

1. Overall Procedures

27. The "paper hearing" system that the Part 65 rules establish for represcription proceedings allows for notices of appearance, initial submissions, responsive submissions, rebuttals, limited discovery, possible cross examination, proposed findings of fact and conclusions, reply findings and conclusions, possible oral argument, and possible use of separated trial staff. We believe that this system goes far beyond what is necessary to achieve the goals of our represcription proceedings. We propose to replace it

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[25] For instance, if we were to require that the change in capital costs persist for six months, there would be at least six months between any future represcription and the beginning of the subsequent represcription proceeding.

with the notice and comment system we describe below. We invite comment on each aspect of this system as well as on alternatives to this system.[26]

28. Under the system we propose, the triggering event would initiate either a represcription proceeding or an inquiry as to whether a represcription proceeding is warranted.[27] If the triggering event initiates a represcription proceeding or, under a semi-automatic trigger, our inquiry shows that a represcription proceeding is warranted, we would issue a notice announcing the beginning of a represcription proceeding. This announcement would also establish a procedural schedule for the proceeding.

29. The schedule would depend, in part, on whether we require information to be filed at the start of a represcription proceeding. If information is required, the notice would establish a deadline for submitting it. We contemplate that the filing companies would make this information available to all interested persons.

30. There are a number of options for the remainder of the schedule, and we invite commenters to discuss which schedule would be most conducive to reducing the burden of the represcription process while protecting the rights of interested persons. We tentatively conclude that the pleading cycle should include initial comments and replies, and we request comment on whether we should also permit rebuttals. We also tentatively conclude that notices of appearance, proposed findings and conclusions, reply findings and conclusions, and separated trial staff are unnecessary and should not be included in future represcription proceedings. We invite comment on these tentative conclusions.

31. The Part 65 rules specify limits of 70 pages for initial submissions, 50 pages for responsive submissions, and 35 pages for rebuttals. We propose to reduce these limits to 50 pages for initial comments, 35 pages for replies, and, if applicable, 25 pages for rebuttals. We believe that these reduced limits will help focus represcription proceedings, without preventing any party from presenting its arguments. We request comment on this proposal and on whether further reductions are warranted.

2. Discovery

32. Section 65.103(a) of our rules permits written interrogatories and requests for documents directed to any rate of return submission and "upon any matter, not privileged, that will demonstrably lead to the production of

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[26] Because represcription is rulemaking, not adjudication, under the Administrative Procedures Act, we believe simple notice and comment would be sufficient for represcription proceedings. See 5 U.S.C. §551(4)-(5), (7); AT&T v. FCC, 572 F.2d 17 (2d Cir. 1978); see also Vermont Yankee Nuclear Power Corp. v. Natural Resources Defense Council, 435 U.S. 519 (1978); United States v. Florida East Coast Railway Co., 410 U.S. 224 (1973).

[27] See Part III(C), supra.

material, relevant, decisionally significant evidence."[28] Requests for discovery are due within fourteen days after the filing of the submission to which they relate. Oppositions are due seven days thereafter.[29]

33. In adopting the Part 65 rules, the Commission anticipated that these discovery procedures would eliminate the wide ranging searches for underlying assumptions and supporting data that had characterized trial-type hearings, without preventing any party from making legitimate use of discovery.[30] We believe that this rule has been a qualified success. Although it contributed to the development of a full and fair record in the 1990 represcription proceeding, it did so only after considerable effort by the parties and the Commission staff.[31] This effort was required because the current rules provide little guidance on what should be produced through discovery and because they require the Chief, Common Carrier Bureau (Bureau), to rule on discovery requests prior to any involuntary discovery.

34. We believe that the process of developing a full and fair record in represcription proceedings can be further streamlined, and we invite comment on how this may be done. As an initial matter, we believe it possible to identify and require the automatic disclosure of much, if not all, of the information that would be made available through discovery. For example, one useful role of discovery during the 1990 represcription proceeding was to ensure the general availability of studies, financial analysts' reports, and other documents the parties' experts relied upon in preparing their presentations. We propose to require each party to future represcription proceedings to file these items with the Commission and to serve them on the other parties. We request comment on this proposal. We invite commenters to identify any other categories of information for which automatic disclosure should be required. We also invite the commenters to identify any categories of information they believe should be protected from automatic disclosure as well as the reasons why protection would be appropriate.

35. Second, Section 65.102(a) of our rules[32] authorizes the Bureau to require participants in any represcription proceeding to submit data or studies that are reasonably calculated to lead to the development of a full and fair record in that proceeding. Information requests pursuant to this rule played a large role in developing the record in the 1990 represcription

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[28] 47 C.F.R. §65.103(a).

[29] 47 C.F.R. §65.103(b).

[30] Phase II Order, at para. 61; Supplemental Notice, at paras. 109-10.

[31] See, e.g., Represcribing the Authorized Rate of Return for Interstate Services of Local Exchange Carriers, Order, 5 FCC Rcd 2091 (Com. Car. Bur. 1990).

[32] 47 C.F.R. §65.102(a).

proceeding.[33] We invite commenters to address whether expanding the role of Bureau information requests would reduce or eliminate the need for discovery by the parties, and thereby decrease the overall burden of the represcription process. We urge parties discussing this issue to list specific items that they believe should, or should not, be the subject of Bureau information requests. Any commenter that considers such requests inadequate to ensure the development of a full and fair record in future represcription proceedings also should describe in detail the kinds of items for which discovery might remain necessary.

36. Third, if discovery is to be retained, we believe that it should not include written interrogatories. That form of discovery appears to be ill suited to eliciting decisionally significant information in rulemaking proceedings that are as dependent on expert economic analysis as represcription proceedings.[34] As our experience in the 1990 represcription proceeding confirms, interrogatories add little, if anything, to the record in represcription proceedings other than multiple reiterations of the parties' positions. Therefore, we tentatively conclude that written interrogatories should not be allowed in future represcription proceedings. We invite comment on this tentative conclusion.

37. Finally, we invite comment on how discovery should proceed in the event it is retained. Under the current rules, discovery requests must be filed with the Commission, subjected to pleading cycles, and addressed by the Bureau prior to any involuntary discovery.[35] We believe that there would be no reason to change this procedure should we adopt our proposals to require the automatic disclosure of certain documents, expand the role of Bureau information requests, and eliminate written interrogatories. Under such circumstances, discovery would appear less likely to elicit decisionally significant information and Bureau review of discovery requests would appear consistent with our goal of reducing the burdens of the represcription process. If, however, we do not adopt those proposals, we believe that requiring parties to represcription proceedings to comply with discovery requests unless they seek and obtain protective orders might facilitate discovery without burdening parties. We invite commenters to address these approaches as well as

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[33] See, e.g., Represcribing the Authorized Rate of Return for Interstate Services of Local Exchange Carriers, Order, 5 FCC Rcd 543 (Com. Car. Bur. 1990). The rules require service on all parties of information filed in response to staff requests. 47 C.F.R. §65.102(c)(4).

[34] In contrast, as our proposals for formal complaint proceedings recognize, interrogatories can be a useful tool for resolving factual disputes among parties to adjudicatory proceedings. Amendment of Rules Governing Procedures to Be Followed When Formal Complaints Are Filed Against Common Carriers, Notice of Proposed Rulemaking, CC Docket No. 92-26, 7 FCC Rcd 2042 (1992).

[35] 47 C.F.R. §65.103(b). Even in the absence of opposition, discovery is not due until fourteen days after release of an order granting the discovery request. Id.

other alternatives for reducing discovery burdens. We also invite commenters to address the procedural schedule we should employ if we adopt a notice and comment system that allows for discovery.

3. Cross-examination and Oral Argument

38. The Part 65 rules permit oral cross-examination and oral argument in represcription proceedings in certain circumstances. To obtain cross-examination, the requesting party must show that the use of written procedures would be prejudicial; that cross-examination is necessary to achieve a full and fair record; that written procedures are inadequate to decisively resolve genuine, substantial, material questions of fact; and that only cross-examination can decisively resolve those questions.[36] To obtain oral argument, the requesting party must show that oral argument is necessary for a full and fair record, that written argument would be prejudicial, that due and full consideration of all matters of fact and law require oral argument, and that written procedures would not produce the benefits expected from oral argument.[37]

39. Our authority to order cross-examination and oral argument in rulemaking proceedings stems from Section 4(j) of the Communications Act of 1934, as amended, which authorizes this Commission to "conduct its proceedings in such manner as will best conduce to the proper dispatch of business and to the ends of justice."[38] Uniquely among our rules, Part 65 attempts to particularize this overall statutory standard by describing the circumstances that would warrant cross-examination and oral argument in rulemaking proceedings. In so doing, the rules imply that represcription proceedings somehow differ from other rulemaking proceedings, at least in regard to the utility of cross-examination and oral argument. We believe that this implication is incorrect and that no useful purpose would be served by retaining special rules for cross-examination and oral argument in represcription proceedings.[39] Therefore, we propose to repeal those rules. We request comment on this proposal. In the event we implement this proposal, we would retain our overall authority to order cross-examination and oral argument in appropriate circumstances.[40]

4. Participation and Filing Requirements

40. The Part 65 rules require exchange carrier holding companies meeting certain specified criteria to participate in represcription proceedings. These

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[36] 47 C.F.R. §65.104.

[37] 47 C.F.R. §65.106.

[38] 47 U.S.C. §154(j).

[39] We note that no party to the 1990 represcription proceeding requested cross-examination or oral argument.

[40] See 47 U.S.C. §154(j); 47 C.F.R. §1.423.

mandatory participants must file notices of appearance and initial submissions. They must also respond to any Bureau information requests and comply with any discovery orders.[41]

41. Presently, the only holding companies that meet the criteria for mandatory participation are the RHCs. We question whether we should continue to rely on these companies as our primary source of information in represcription proceedings, given our regulation of the BOCs under price caps. Specifically, it may be that RHC data would no longer be useful in the represcription process, because price cap LECs and rate of return LECs may no longer face comparable risks in the provision of interstate access service. We invite interested persons to explore alternatives for obtaining the information required to support future represcription processes. In this regard, we observe that while the RHCs or their affiliates may be the only source of some of the information we propose to require, it may also be that most or all of that information could be collected and submitted by a LEC organization, such as the National Exchange Carrier Association, Inc. (NECA). Therefore, we propose to require LECs or LEC holding companies to submit to NECA any information that might be needed to support our triggering and cost of capital methodologies, to require NECA to process this information in accordance with our rules, and to make NECA the only mandatory participant in represcription proceedings. We invite comment on these proposals and on the impact their implementation would have on NECA's overall expenses. Because we see NECA's responsibility as one limited to data collection and processing, we anticipate that this impact would be minimal.

42. In the event we implement these proposals, we also propose to amend Section 69.603 of our rules[42] to authorize NECA to participate in our represcription processes. We propose, in addition, to require NECA to classify the costs of such participation and compliance as Category I expenses.[43] This classification would allow NECA to include those costs in its interstate revenue requirement and revenue distribution computations. We also invite comment on these proposals.

5. Requests for Individualized Rates of Return

43. Sections 65.101 and 65.102 of our rules[44] establish procedures by which LECs may seek rates of return different from the prescribed unitary, overall rate of return as well as substantive standards for evaluating

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[41] See, e.g., 47 C.F.R. §§65.100(a)(1), 65.102(a), 65.103(a), 65.200.

[42] 47 C.F.R. §69.603.

[43] Our rules require NECA to classify its costs as either Category I expenses, which generally consist of those expenses NECA incurs in furtherance of its tariffing and revenue distribution functions, and Category II expenses, which encompass those expenses not classified as Category I. See 47 C.F.R. §69.603(h).

[44] 47 C.F.R. §§65.101, 65.102.

petitions for such treatment. While petitions for individualized treatment may be filed at any time, the rules contemplate that they will be filed on the date responsive rate of return submissions are due.[45] The rules require each LEC that seeks individualized treatment to show exceptional facts and circumstances that are not transitory and that would justify individualized treatment for at least two years. If the petition is filed on a date other than the deadline for filing responsive submissions, the LEC must also provide compelling evidence that its fluctuation in earnings requirements is not the result of short term fluctuations in the cost of capital or similar events.[46] Regardless of when the petition is filed, the rules specify that it will be granted only if the unitary, overall rate of return "is so low as to be confiscatory because it is outside the zone of reasonableness for the individual carrier's required rate of return for exchange services."[47]

44. While we propose no change in our policy of prescribing a unitary, overall rate of return for rate of return LECs, we believe that we must allow LECs the opportunity to seek individualized rates of return that differ from the unitary rate.[48] We also believe that we should make no change in the standard for granting an individualized rate of return. However, we propose to amend our rules regarding requests for individualized rates of return to the extent necessary to ensure those rules' consistency with our overall represcription procedures.[49] We invite comment on this proposal.

E. Cost of Capital Methodologies

1. Overview

45. The system established in the Part 65 rules contemplates that we will use a weighted average cost of capital calculation to estimate the cost of capital for LEC interstate access service. This calculation requires the determination of cost of equity, cost of debt, and capital structure components. The Part 65 rules specify methodologies for determining each of these components and require the filing of data supporting the specified methodologies for inclusion in the record in represcription proceedings. Under those rules, parties to represcription proceedings may urge, and this Commission may adopt, cost of capital methodologies other than the specified methodologies.

46. In this section, we address questions regarding the methodologies

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[45] See 47 C.F.R. §§65.101(b); 65.102(c)(2).

[46] 47 C.F.R. §§65.101(b).

[47] 47 C.F.R. §§65.101(a).

[48] See 47 U.S.C. §203.

[49] For example, if we were to specify a page limit of 50 pages for initial comments, we would specify the same page limit for requests for individualized treatment. See Part III(D)(1), supra.

used to determine the cost of capital for LEC interstate access service. While we intend to continue our weighted average cost of capital approach, we invite comment on alternative methodologies for determining the components of that average. We intend in this rulemaking to select methodologies for determining these components and to incorporate the selected methodologies into our rules.

47. We also address the role the specified methodologies should play in future represcription proceedings. With regard to the cost of equity determination, we propose to retain our policy of determining the weight to be accorded any particular methodology at the point we represcribe the authorized interstate rate of return. With regard to each other cost of capital component, we propose to adopt methodologies that would be presumptive or conclusive in future represcription proceedings.[50] We request the commenters to address whether these proposals are consistent with our goals in this proceeding.

2. Surrogates for LEC Interstate Access Service

a. Potential Surrogates

48. Many of the cost of capital methodologies we consider below require stock price and other data that measure investor expectations regarding the cost of capital for LEC interstate access service. Since LECs do not issue stock or borrow money solely to support interstate access service, it is impracticable, if not impossible, to measure investor expectations regarding that cost of capital directly. Instead, it is necessary to select a company or group of companies to act as a surrogate for the entities that provide LEC interstate access service. The surrogate should face risks similar to those the remaining rate of return LECs encounter in providing that service.

49. In the 1990 represcription proceeding, we considered a number of potential surrogates for the LEC interstate access industry. We found that the RHCs were appropriate surrogates, despite changes in investor expectations resulting from their increasing diversification into nonregulated enterprises.[51] We also used cost of equity estimates for firms within the S&P 400 and 100 large electric utilities as benchmarks for assessing other cost of equity estimates.[52]

50. We believe that the RHCs, the S&P 400, and the 100 large electric

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[50] A presumptive methodology would be used in future represcription proceedings unless the record were to show that it would produce unreasonable results.

[51] 1990 Represcription Order, 5 FCC Rcd at 7517-19, paras. 83-87, 98-102; see also id. at 7510-11, paras. 31-34.

[52] Id. at 7513-7514, paras. 57-60; id. at 7528, paras. 182-85. We screened both groups of companies to exclude those that paid no dividends or whose DCF estimates did not at least equal the average yield on corporate bonds rated "A" by Moody's Bond Record (Moody's).

utilities all have potential for future use as surrogates for the interstate access operations of the remaining rate of return LECs. We are concerned, however, that investors may not regard these groups of companies as continuing to face overall risks comparable to those of providing interstate access service on a rate of return basis. For example, our price cap initiative and further RHC diversification may make investor perceptions of the RHCs' risks dissimilar to those the remaining rate of return LECs encounter in providing interstate access service.[53] We invite comment on whether investors regard the RHCs', the S&P 400 firms', and the 100 large electric utilities' risks as different from those of the remaining rate of return LECs and, if so, how we might adjust for those differences.[54] We also invite the commenters to identify other potential surrogates for the interstate access service of the remaining rate of return LECs. We request that commenters on this issue address the extent to which investors regard these potential surrogates as facing risks that differ from those the remaining rate of return LECs face in providing interstate access service.

b. Part 65 Comparable Firms Analysis

51. Section 65.400 of our rules[55] specifies criteria for determining when firms have risk characteristics that are comparable to those of interstate access service. This rule requires RHCs to screen all corporations listed on the New York Stock Exchange (NYSE) for the specified criteria. Firms that meet the criteria are deemed to be comparable to the entities that provide interstate access service.

52. In the 1986 represcription proceeding, we found significant problems with the screening approach and gave analyses relying on that approach little weight.[56] In Docket 87-463, we attempted to correct these problems by proposing to amend Section 65.400 to incorporate a cluster analysis. Under this approach, different criteria would be used to assign NYSE listed companies into discrete groups and to evaluate the risk characteristics of interstate access service. The group whose risk characteristics appeared closest to those of interstate access service would be deemed to be comparable to the entities that provide that service.[57] Although several parties presented cluster analyses in the 1990 represcription proceeding, we found that those analyses failed to identify firms whose risks were comparable to those of interstate access service. Accordingly, we gave those analyses no weight in our cost of

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[53] In the 1990 Represcription Order, we recognized that investors perceive nonregulated businesses as riskier than interstate access service. Id. at 7517, paras. 84-87.

[54] Section III(E)(3)(a)(iii), infra, addresses one potential adjustment regarding the S&P 400.

[55] See 47 C.F.R. §65.400.

[56] 1986 Represcription Order, at paras. 19-23.

[57] See 1987 Notice, 2 FCC Rcd at 6493-94, paras. 18-28.

capital determination.[58]

53. Our experiences with both the screening approach and cluster analysis demonstrate the difficulty of specifying selection criteria for comparable firms that "accurately portray all the relevant dimensions of risk."[59] Therefore, we propose to repeal Section 65.400. We invite comment on this proposal.

3. Cost of Equity

a. DCF

i. Overview

54. The DCF methodology employs dividend and stock price data to estimate the return on equity companies must earn to meet investor expectations. It does so by positing that:

Ke = D/P + G, where

Ke = cost of equity,

D = estimated annual dividend on a share of common stock,

P = the price of a share of common stock, and

G = estimated long-term growth rate of earnings.

According to this formula, the return investors expect to earn on a share of common stock (Ke) equals the dividend yield they expect from that share (D/P) plus the long-term growth they expect in earnings (G).

ii. "Historical" DCF

55. The Part 65 rules require RHCs to include in their initial submissions cost of equity estimates calculated using two "historical" versions of the DCF formula. Both of these versions rely on RHC dividend and stock price data from the two calendar years preceding the submission's filing.[60] In the two represcription proceedings conducted under the Part 65 rules, we gave very little or no weight to the results these data generated.[61] We found that those results neither fully reflected current market requirements

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[58] 1990 Represcription Order, 5 FCC Rcd at 7526, paras. 161-66.

[59] Id. at 7526, para. 166; see 1986 Represcription Order, at paras. 19-23.

[60] 47 C.F.R. §65.303.

[61] 1990 Represcription Order, 5 FCC Rcd at 7512, para. 48 (no weight); 1986 Represcription Order, at para. 36 (very little weight).

nor revealed the trends in those requirements.[62]

56. We continue to believe that the "historical" versions of the DCF formula in the Part 65 rules are inconsistent with the forward-looking nature of DCF analysis.[63] Accordingly, we propose to delete the "historical" DCF formulas from our rules. We invite comment on this proposal.

iii. "Classic" DCF

57. In the "classic" DCF formula, D is the current annualized dividend, P is the current price of a share of common stock, and G is the anticipated long-term growth rate of dividends, stock price, and earnings. In the 1990 represcription proceeding, the Commission relied primarily on this formula in estimating the cost of equity for LEC interstate access service. The Commission found that the results this formula generated were entitled to great weight.[64] We invite comment on whether we should apply this formula in future represcription proceedings. We also request the commenters to address precisely how we might apply this formula in those proceedings. To guide the commenters, the following raises issues regarding the formula's application.

58. Application to S&P 400. In the 1990 represcription proceeding, we determined that S&P 400 firms that paid dividends and whose DCF estimated cost of equity equalled or exceeded the average yield on corporate bonds rated "A" by Moody's were roughly representative of the universe of nonregulated firms. By ranking these firms in order of their DCF estimates, we were able to depict the returns investors required for firms with average, below average, and above average costs of capital. Because we believed that interstate access service is less risky than the average publicly-traded firm, we found that the lower half of this S&P 400 group provided the most useful information for determining the cost of equity for that service. This lower half consists of the lowest and second lowest quartiles of our S&P 400 group.[65]

59. We examined the historical relationship between the RHCs' DCF cost of equity and the DCF cost of equity for our S&P 400 group. We found that the RHCs' DCF cost of equity had been well below the median for this group since 1984, the first year for which DCF cost of equity data are available. We also found that between 1984 and 1987 the RHCs' DCF cost of equity had been between the midpoint of the lowest quartile and the midpoint of the second lowest quartile of this group, and that an upward adjustment of 75-100 basis points in recognition of the RHCs' cellular operations would place the RHCs' DCF cost of

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[62] 1990 Represcription Order, 5 FCC Rcd at 7512, para. 48.

[63] Id.

[64] Id. at 7528-7529, para. 187.

[65] Id. at 7513-14, paras. 58-59; id. at 7526, para. 162; id. at 7528, paras. 182-85.

equity between those two midpoints during subsequent periods.[66] We used the range established by these midpoints as a benchmark for assessing the reasonableness of other cost of equity estimates.[67]

60. We believe that the range defined by these two midpoints may provide an appropriate estimate of the "zone of reasonableness" within which future represcriptions should fall. We invite comment on whether we should incorporate this range into our rules and, if so, whether we should require DCF data on this range to be filed with the Commission and included in the record in future represcription proceedings.

61. Stock prices. In the 1990 represcription proceeding, our primary cost of equity conclusions were based on a series of then recent, monthly DCF estimates for the RHCs.[68] The stock price used for each month was the average of that month's high and low stock prices. We tentatively conclude that the we should continue to use this average if we employ the DCF methodology in future represcription proceedings. We seek comment on this tentative conclusion.

62. Dividends. One factor in the DCF formula is the annual dividend investors expect for each share of common stock in the company whose cost of equity is being estimated. To estimate annual dividends in the 1990 represcription proceeding, we increased then-current annualized dividends by one-half the median Institutional Brokers Estimate System (IBES) growth estimate for annual growth in those dividends.[69] We found that increasing annualized dividends by the entire IBES estimated growth rate would overstate estimated annual growth "because the BOCs' dividends have been increased during the past six months and the stock prices we use [in DCF calculations] are based on those higher dividends...."[70] We continue to believe that the method used in the 1990 represcription proceeding produces fair and reasonable results. We tentatively conclude that we should use this method if we employ the DCF methodology in future represcription proceedings. We seek comment on this tentative conclusion.

63. Growth. An additional factor in the DCF formula is the long-term growth investors forecast for the earnings of the company whose cost of equity is being estimated. In both the 1986 and 1990 represcription proceedings, we

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[66] Exhibit A to this Notice depicts these quartiles as well as the RHCs' estimated DCF cost of equity through March 1992.

[67] 1990 Represcription Order, 5 FCC Rcd at 7526, para. 162; id. at 7528, paras. 182-85.

[68] Id. at 7514, para. 63.

[69] 1990 Represcription Order, 5 FCC Rcd at 7514, para. 66.

[70] Id.

used the IBES median forecast of long-term growth.[71] We tentatively conclude that we should continue to use the median IBES forecast of long-term growth in the DCF formula if we employ that formula in future represcription proceedings. We seek comment on this tentative conclusion.

64. Quarterly compounding. In the 1986 and 1990 represcription proceedings, we rejected LEC arguments that a compounded quarterly dividend should be used in the DCF formula to account for the payment of dividends on a quarterly, rather than annual, basis.[72] While we recognized that experts were divided as to the technical effect of using a compounded dividend, we stated that there was no evidence that the investment community uses a quarterly-compounding growth model in a way that affects market prices. We also stated that even if a compounded quarterly dividend were appropriate, any increased accuracy resulting from its use would be too minor to offset the increased complexity of DCF calculations.[73]

65. We continue to believe that quarterly compounding would increase the complexity of DCF calculations without providing a commensurate increase in accuracy. Therefore, we tentatively conclude that we should not use quarterly compounding in any DCF formula. We seek comment on this tentative conclusion.

66. Flotation Costs. When a company issues stock, it incurs out-of-pocket expenses to get the stock to investors or their agents. Companies may also incur an indirect cost -- a temporary reduction in the market value of the stock because of the issuance of additional shares. These costs are referred to as flotation costs. In Docket 84-800, the Commission allowed a one-time, cost of equity adjustment of 10 basis points (0.1%) for flotation costs, but stated that no subsequent upward adjustments should be permitted.[74] In the 1990 represcription proceeding, we allowed no flotation adjustment, in part because the parties that urged such an adjustment relied upon general theory, rather than attempting to show that an adjustment was necessary to allow recovery of actual costs.[75]

67. In Docket 84-800, LECs failed to show a need for a flotation cost adjustment above the one-time 10 basis point adjustment allowed in that proceeding. In the 1990 represcription proceeding, LECs failed to show a need for any flotation cost adjustment whatsoever. In view of these failures, we doubt that any such showing is possible. However, in the interest of developing a complete record in this proceeding, we will give interested

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[71] 1990 Represcription Order, 5 FCC Rcd at 7515, paras. 67 & 69; 1986 Represcription Order, at para. 15.

[72] See, e.g., id. at 7515, para. 72.

[73] Id.

[74] Phase II Order, at para. 43; see also Phase II Reconsideration Order, 104 FCC 2d at 1432, para. 62.

[75] 1990 Represcription Order, 5 FCC Rcd at 7516, para. 75.

persons a final opportunity to show that a flotation cost adjustment is necessary to allow recovery of actual costs. We invite comment on this matter.

b. Risk Premium

i. Overview

68. Risk premium analyses estimate the cost of equity by adding a risk premium to the current yield on a "risk-free" investment, such as long-term United States Treasury bonds. Traditionally, such analyses have determined the risk premium by comparing historically realized returns on stocks and bonds. As we explained in the 1990 represcription order:

> A bond's yield is simply the discount (interest) rate that makes the present value of its contractual cash flow equal to its market value. Since the cash flows are fixed, if the bond goes up in price, the yield must go down. An increase in the price of a stock, however, may leave the stock's expected return unchanged if the price rose to adjust for higher anticipated profits rather than lower investor perceived risk. Risk premium analyses solve this problem by comparing the past returns (capital gains, dividends and interest, divided by the market price) on stocks and bonds.[76]

69. A variant of this methodology, the capital asset pricing model (CAPM) uses a risk premium based on the differences in returns on very low risk debt and the overall stock market. To estimate a particular company's cost of equity, CAPM uses the variance of the company's stock price relative to the market as a whole (beta) to adjust the premium. The CAPM formula is:

COE = RF + (beta * RP), where

COE is the cost of equity estimate,

RF is the current yield on very low risk debt,

RP is the analyst's estimate of the difference in return between low risk debt and the overall stock market, and

Beta is an estimate of the difference in risk of the stock for which the cost of equity estimate is being made and the overall risk of stock market investments.

70. In the 1990 represcription proceeding, we considered five CAPM analyses. Although we recognized CAPM's potential as a methodology for estimating the cost of equity as reliably as the DCF methodology, we gave no

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[76] Id. at 7522, para. 133.

weight to the CAPM analyses before us. We found that those analyses used risk premiums that appeared to be higher than those analysts used in developing investment recommendations. We also found the CAPM analyses before us overstated the relative risk of stocks that are less risky than the overall stock market.[77]

ii. Proposals

71. We continue to believe that risk premium analyses, including CAPM analyses, have potential as cost of equity methodologies. We are concerned, however, that the problems which precluded reliance on those analyses during the 1990 represcription proceeding -- unrealistic risk premiums and betas -- may preclude acceptance of risk premium methodologies in future represcription proceedings. We invite comment on how these problems might be solved.

72. In this regard, it appears that risk premiums derived from historical stock and bond yields may be overly dependent on the sample period. As Exhibit B to this Notice shows, the difference between common stock returns and long-term United States Treasury bond yields ranged from -49.3% to 45.2% on an annualized basis from 1926 to 1988. Such wide fluctuations on realized returns make the sample period crucial to any analyses that relies on historical yield differentials.[78] In these circumstances, we question whether we should rely on historical stock and bond yields to imply a risk premium. We request comment on this matter.

73. We have analyzed the Commission's prior represcription orders in an attempt to minimize the problems associated with implying a risk premium from historical data. To perform this analysis, we compared the costs of equity implied in prior Commission orders[79] with then-current bond yields. Exhibit C provides the results of our analysis. That exhibit shows that the difference between the costs of equity implied in Commission orders and long-term United States Treasury bond yields range from 3.5% to 6.6%. We invite comment on whether we can use these implied risk premiums either as tool for independently determining the authorized rate of return on LEC interstate access service or as a benchmark for evaluating other cost of equity estimates.

74. We also invite comment on whether relying on stock market data reflecting investor expectations, such as DCF cost of equity estimates for the

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[77] Id. at 7510, paras. 32-33; id. at 7523, para. 139.

[78] For instance, as Exhibit B shows, during the twenty-year period ending in 1988 the average difference between stock and long-term United States Treasury bond yields was 2.0%. During the ten-year period ending in 1988, that difference was 6.0%.

[79] We use implied costs of equity because we prescribe overall rates of return, rather than returns on equity. For any given proceeding, the implied cost of equity is obtained by dividing the prescribed overall rate of return minus the product of the cost of debt times the percentage of debt in the capital structure by the percentage of equity in the capital structure.

S&P 400, might provide a forward-looking risk premium. Exhibit D shows that from the first quarter of 1982 through the first quarter of 1992, the difference between S&P 400 DCF cost of equity estimates for the lower half (first and second quartiles) of the S&P 400 and yields on public utility "Aa" rated bonds ranged from 1.5% to 4.4%, for a variance of only 290 basis points. We invite comment on how we might use this range to determine the authorized rate of return on LEC interstate access service.

75. Finally, we request commenters supporting use of a risk premium based on the above analyses or alternative analyses to address the role that risk premium should play in our processes. We invite comment on whether we should incorporate any risk premium analysis that we adopt into our rules and, if so, whether we require data supporting that analysis to be included in the record of future represcription proceedings.

4. Cost of Debt

76. The cost of debt component of the weighted average cost of capital for LEC interstate access currently specified in Part 65 is a composite of the RHCs' embedded costs of debt.[80] We used this composite in the 1990 represcription proceeding, despite LEC arguments that we should use a composite of the BOCs' embedded costs of debt.[81] Although it is possible that continued use of the RHCs' embedded costs of debt might be reasonable, we question whether another methodology would be better suited to our task. Thus, we invite comment on whether we should continue to use the RHCs' embedded costs of debt as the cost of debt component in future represcription proceedings.

77. We intend to consider five methodologies for calculating the cost of debt component: (1) using a composite of the RHCs' embedded cost of debt; (2) using a composite of the BOCs' embedded costs of debt; (3) using a composite of the embedded costs of debt of LECs that have $100 million or more in annual revenue; (4) using a composite of the embedded costs of debt of holding companies that own such LECs; and (5) using publicly available data on the cost of corporate debt. We request interested persons to address whether these methodologies would properly reflect the cost of debt for LEC interstate access service and further our goal of reducing the burdens of the represcription process.

78. The first four approaches would require calculation of the embedded costs of debt for individual companies, and we invite comment on how those calculations should be performed. Section 65.301 of our rules[82] presently requires each RHC to calculate its embedded cost of debt using a procedure under which each outstanding debt issue must be considered separately. We

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[80] 47 C.F.R. §§65.201, 65.300.

[81] Since the RHCs' and the BOCs' composite costs of debt were 8.76% and 8.81%, respectively, this decision had no more than a marginal effect on our overall cost of capital determination.

[82] 47 C.F.R. §65.301.

believe that this procedure may be unnecessarily burdensome and that we could determine any individual company's cost of debt by dividing the company's annual interest expense by its average outstanding debt during that year. We invite comment on this methodology as well as on other alternatives for calculating the embedded debt costs of particular companies.

79. We also believe that we should change how the embedded cost of debt is calculated even if we continue to require outstanding debt issues of particular companies to be considered separately. When debt is issued at a premium above or a discount below the principal amount stated on the debt instrument, the effective rate of interest on the issue differs from the rate stated on that instrument.[83] The formulas in our current rate of return rules attempt to compensate for this by requiring that the premium or discount be amortized on a straight-line basis over the term of the debt.[84] This results in the calculation of a different interest rate for each instrument each year. The method is inconsistent with generally accepted accounting practices (GAAP). Under GAAP, carriers account for premiums and discounts using the interest method. Under this method, the interest rate for each instrument equals the actual amount of interest expense implicit in the debt transaction. This rate is known when the debt is issued and remains constant over the term of debt. The amortization amount, however, is recalculated annually so that the implicit interest rate is maintained.[85] We believe that the method in our current rules misstates the actual cost of debt and that the interest method accurately states that cost. Therefore, we tentatively conclude that we should use the interest method if we retain our requirement that each outstanding debt issue be considered separately. We invite comment on this tentative conclusion.

80. The final approach, which would rely on publicly available data on the cost of corporate debt, is based on our own analysis of how we might simplify the process of determining the cost of debt for LEC interstate access service. If we adopt this approach, we propose to distinguish between long-term debt (i.e., debt with a term of one year or more) and short-term debt (i.e., all other debt). We propose to use a composite of the yields at issuance on a random sample of outstanding corporate bonds rated "Aa" or better by Moody's to determine the cost of the long-term debt. We believe that such a sample would fairly represent the bond ratings and age distributions that would occur if bonds were issued solely to support LEC interstate access service. To determine the cost of the short-term debt, we propose to use the ten-day average of unsecured notes sold through dealers by major corporations. We believe that this average provides a reasonable proxy for cost of short-term debt for LEC interstate access service. We invite commenters to discuss these proposals as well as other methods for determining the cost of debt for that service. We also invite comment on whether we should select a cost of debt

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[83] The effective rate of interest is lower with premiums and higher with discounts.

[84] See 47 C.F.R. §65.301.

[85] See, e.g., Welsch and Zlatkovich, Intermediate Accounting, 651-56 (8th ed. 1989); see also id. at 641.